No. 20170591-SC

IN THE
SUPREME COURT OF THE STATE OF UTAH

HEALTHBANC INTERNATIONAL, LLC, a New Hampshire limited liability company, BERNARD FELDMAN, an individual,
Plaintiffs,
v.
SYNERGY WORLDWIDE, INC., a Utah corporation, and NATURE'S SUNSHINE PRODUCTS, INCORPORATED, a Utah corporation,
Defendants.

On certified question of law from the United States District Court for the District of Utah, Honorable Jill N. Parrish, Case No. 2:16-cv-00135

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JURISDICTION

This case has been presented to this Court on one certified question from the United States District Court for the District of Utah. This Court has jurisdiction under section 78A-3-102(1) of the Utah Code.

CERTIFIED QUESTION

Does the economic loss rule bar a cause of action for fraudulent inducement that is based on pre-contract misrepresentations that induce another party into entering into a contract?[1]

INTRODUCTION

This Court should answer the United States District Court's certified question in the negative because the economic loss rule does not bar a cause of action for fraudulent inducement that is based upon pre-contractual misrepresentations. "The economic loss rule is a judicially created doctrine that marks the fundamental boundary between contract law, which protects expectancy interests created through agreement between the parties, and tort law, which protects individuals and their property from physical harm by imposing a duty of reasonable care." SME Indus. Inc. v. Thompson, Ventulett, Stainback & Assocs., Inc., 2001 UT 54, ¶ 32, 28 P.3d 669 (citing American Towers Owners Ass'n, Inc. v. CCI Mech., Inc., 930 P.2d 1182, 1190 (Utah 1996)). The economic loss doctrine asks "whether

[1] US Fid. v. US Sports Specialty, 2012 UT 3, ¶ 9, 270 P.3d 464 ("A certified question from the federal district court does not present us with a decision to affirm or reverse a lower court's decision; as such, traditional standards of review do not apply. On certification, we answer the legal questions presented without resolving the underlying dispute.") (internal quotation marks omitted).

a duty exists independent of any contractual obligations between the parties." Davencourt at Pilgrims Landing Homeowners Ass'n v. Davencourt at Pilgrims Landing, LC, 2009 UT 65, ¶ 27, 221 P.3d 234, 244 (citing Hermansen v. Tasulis, 2002 UT 52, ¶ 17, 48 P.3d 235). If an independent duty exists, the "economic loss rule does not bar a tort claim because the claim is based on a recognized independent duty of care and thus does not fall within the scope of the rule." Id.

The economic loss doctrine has never been extended to intentional torts committed prior to a contract, and this Court should decline any invitation to do so here. In particular, extending the economic loss rule to fraudulent inducement claims in commercial disputes would be unwise because: (1) fraudulent inducement is an intentional tort committed prior to the formation of any contract, and therefore, falls outside the traditional scope of the economic loss rule; (2) the tort of fraudulent inducement is based upon the breach of an independent tort duty, namely, the duty to be honest in commercial dealings and to candidly represent facts basic to the transaction; and (3) extending the doctrine to fraudulent inducement claims would effectively reward a party for its misconduct by restricting the remedies that are available to those harmed by intentional misconduct.

For these reasons, Defendants Synergy Worldwide, Inc. and Nature's Sunshine Products Incorporated urge this Court to answer the United States District Court's certified question in the negative, and to find that economic loss doctrine does not bar a claim for fraud in the inducement of a contract.

DETERMINATIVE PROVISIONS

The economic loss rule is a "judicially created doctrine." Davencourt, 2009 UT 65, ¶ 18. There are no determinative provisions of statutory or constitutional law that govern the application of the economic loss doctrine in a commercial dispute or in the context of fraudulent claims.

The Utah legislature has, however, codified the economic loss doctrine with respect to claims for defective construction. Utah Code Ann. § 78B-4-513 states, in part:

> **(1)** Except as provided in Subsection (2), an action for defective design or construction is limited to breach of the contract, whether written or otherwise, including both express and implied warranties.
>
> . . .
>
> **(5)** If a person in privity of contract sues for defective design or construction under this section, nothing in this section precludes the person from bringing, in the same suit, another cause of action to which the person is entitled based on an intentional or willful breach of a duty existing in law.

STATEMENT OF THE CASE

This case is a commercial dispute between the plaintiff, HealthBanc International, LLC ("HealthBanc") and Defendants Synergy Worldwide, Inc. ("Synergy") and Nature's Sunshine Products Incorporated ("Nature's Sunshine").

Synergy manufactures, markets, and sells consumer products and services, including nutritional, skin, and personal care products. In 2006, Synergy and HealthBanc discussed a formula for a supplement that HealthBanc purported to own. Pub. R. at 316. During the parties' negotiations, HealthBanc and its representatives made a number of representations, including that HealthBanc owned patent rights and trademark rights to the

formula; that the formula had been developed by its scientific team; that the formula was backed by other experts who could validate it and provide scientific support for the health benefits associated with the formula; and that HealthBanc had the exclusive right to use, assign, or sell the formula and its associated intellectual property rights. Id. at 317–20.

Based on these representations, Synergy agreed to sign a royalty agreement with HealthBanc, pursuant to which Synergy would sell supplements using the proprietary, scientifically-validated formula in exchange for an agreed-upon royalty amount. Id. at 319. Unfortunately, HealthBanc's representations were false: there were no intellectual property rights associated with HealthBanc's formula, and there were no scientific studies or evidence to support the alleged health benefits. Id. at 323.

On February 19, 2016, HealthBanc filed suit against the defendants, claiming that they had breached the royalty agreement by failing to pay certain amounts purportedly due. Id. at 1–26. Synergy filed a counterclaim against HealthBanc, asserting claims for breach of contract, as well as an alternative claim for fraudulent inducement. Id. at 325–30. Synergy also alleged a claim against HealthBanc's principal, Bernard Feldman, for fraud in the inducement, based upon his personal misrepresentations, including misrepresentations concerning the formula's purported intellectual property rights. Id. at 327–30. Among other things, Synergy alleged that it would not have entered into the royalty agreement on the same terms – if at all – had it known that HealthBanc's representations regarding its intellectual property rights were untrue. Id. at 328.

HealthBanc moved to dismiss Synergy's claim for fraudulent inducement, arguing that Utah's economic loss rule barred the claim, since the royalty agreement governed the

subject matter of the alleged pre-contractual misrepresentations. Id. at 158–66. Because the motion presented controlling issues of Utah law, and because this Court had never explicitly ruled upon whether fraudulent inducement is an exception to the economic loss doctrine, the United States District Court for the District of Utah (Jill N. Parrish, D.J.) certified the instant question to this Court. Id. at 516–19. On August 17, 2017, this Court accepted the certification. Id. at 522.

SUMMARY OF THE ARGUMENT

The economic loss rule does not bar a cause of action for fraudulent inducement that is based upon pre-contractual misrepresentations, and such a finding would be inconsistent with Utah law as well as the weight of authority from other jurisdictions. Specifically, extending the economic loss rule to fraudulent inducement claims in commercial disputes would be improper because: (1) fraudulent inducement is an intentional tort committed prior to any contract, and therefore, falls outside the traditional scope of the economic loss rule; (2) the tort of fraudulent inducement is based upon the breach of an independent tort duty, namely, the duty to be honest in commercial dealings and to candidly represent facts basic to the transaction; and (3) extending the doctrine to fraudulent inducement claims would effectively reward a party for its misconduct by restricting the remedies available to those harmed by intentional misconduct.

ARGUMENT

I. The Economic Loss Rule Does Not Bar a Fraudulent Inducement Cause of Action Because the Alleged Wrongful Act Precedes the Contract.

The economic loss doctrine "is a judicially created doctrine that marks" the boundary between contract law and tort law. Davencourt, 2009 UT 65, ¶ 18. The economic loss rule bars the recovery of damages "when a contract covers the subject matter of the dispute." Reighard v. Yates, 2012 UT 45, ¶ 20, 285 P.3d 1168.

In Utah, the economic loss doctrine originated in product liability law, and then evolved to cover construction defect cases for purposes of barring professional negligence claims that were governed by a contract. See, e.g. SME Indus. Inc., 2001 UT 54, ¶ 32; American Towers, 930 P.2d at 1190. This Court has previously identified a number of exceptions to the doctrine, and has previously noted that "fraud may be an exception to the economic loss rule . . . ." Grynberg v. Questar Pipeline Co., 2003 UT 8, ¶ 48, 70 P.3d 1; see also Davencourt, 221 P.3d at 247 (recognizing that at least some claims "lie outside the scope of the economic loss rule.") Although this Court has not yet had the opportunity to rule upon the applicability of the economic loss doctrine to a fraud-in-the-inducement claim in a commercial dispute, the federal courts and several other state appellate courts have determined that fraud in the inducement is not subject to the rule.

For example, the United States District Court for the District of Utah previously addressed this issue in DeMarco v. LaPay, No. 2:09-CV-190 TS, 2012 U.S. Dist. Lexis 117462 (D. Utah Aug. 20, 2012). In that matter, Judge Stewart concluded that a claim for

fraud in the inducement was not barred by the economic loss doctrine, quoting a Tenth Circuit opinion as follows:

> Where a negligence claim is based only on a breach of a contractual duty, the law of contract rightly does not punish the breaching party, but limits the breaching party's liability to damages that naturally flow from the breach. It is an altogether different situation where it appears two parties have in good faith entered into a contract but, in actuality, one party has deliberately made false representations of past or present fact, has intentionally failed to disclose a material past or present fact, or has negligently given false information with knowledge that the other party would act in reliance on that information in a business transaction with a third party. The breaching party in this latter situation also is a tortfeasor and may not utilize the law of contract to shield liability in tort for the party's deliberate or negligent misrepresentations.

Id. at *7–*8 (quoting United Intern Holdings, Inc. v. Wharf (Holdings) Ltd., 210 F.3d 1207, 1227 (10th Cir. 2000)). Several other Utah federal district court decisions have reached the same conclusion.[2]

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[2] See Preventive Energy Solutions, LLC v. NCAP Ventures 5 LLC, No. 2:16-cv-809-PMW, 2017 U.S. Dist. Lexis 4195, at *19–20 (D. Utah Jan. 10, 2017, Judge Warner) (denying motion to dismiss fraud-in-the-inducement claim); BigPayout, LLC v. Mantex Enterprises, Ltd., No. 2:12-CV-1183-RJS, 2014 U.S. Dist. Lexis 146699, at *12 (D. Utah Oct. 14, 2014, Judge Shelby) ("To the extent that these claims arose prior to the formation of the contract, they are independent of the duties the parties undertook upon formation of the contractual agreement."); MP Nexlevel, LLC v. Codale Elec. Supply, Inc., No. 2:08-cv-0727 CW, 2010 U.S. Dist. Lexis 40828 at *15 (holding that "[t]he law, not the contract, imposed a duty on [defendant] not to make material misrepresentations of fact" and refusing to apply economic loss rule as a result); Worldwide Mach, Inc. v. Wall Mach, Inc., No. 2:06-cv-130 DS, 2006 U.S. Dist. Lexis 66432, at *13 (D. Utah Sept. 12, 2006, Judge Sam) (finding that economic loss doctrine did not apply to fraud claim that alleged conduct beyond the duties and liabilities of the contract); Associated Diving and Marine Contractors, L.C. v. Granite Construction Co., No. 2:01-cv-330 DB, 2003 U.S. Dist. Lexis 21560, at *21–*23 (D. Utah July 11, 2003, Judge Dee Benson) (allowing claim for fraud in the inducement to proceed alongside a breach of contract claim because the misrepresentations occurred before the contract had been executed).

The case law from other jurisdictions similarly recognizes that the economic loss rule does not apply to fraudulent inducement claims. In Abi-Najm v. Concord Condominium, LLC, 699 S.E.2d 483 (Va. 2010), the plaintiffs asserted claims in both contract and tort, including a claim for fraudulent inducement based upon the defendant's representations concerning a construction project. Id. at 486. After the project was completed, the plaintiffs discovered that the defendant had installed flooring types that were inferior to those agreed upon (a fact which the defendant knew prior to contracting.) The plaintiffs alleged that they relied on defendant's misrepresentations, and that they either would not have entered into the agreement, or alternatively, would have renegotiated the contract had the facts been disclosed. Id. The Virginia Court rejected the defendant's claim that the tort action was barred by the economic loss doctrine, finding that "[t]he fraud alleged by the [plaintiffs] was perpetrated ... *before* a contract between the two parties came into existence" and therefore, the economic loss rule did not bar the claim. Id. at 490 (emphasis in original).

Similarly, in Van Rees v. Unleaded Software, Inc., 373 P.3d 603 (Colo. 2016), the plaintiff brought three breach of contract claims and numerous tort claims, including a claim for fraudulent inducement based upon the defendant's representations regarding its web design, search-engine optimization, and web hosting capabilities. Id. at 605–06. The defendant moved to dismiss the tort claims based on the economic loss rule, arguing that the subject matter was covered by the parties' contract. The Colorado Supreme Court reversed, stating that the "critical question in this case . . . is not whether [the plaintiff's] tort claims are related to the promises that eventually formed the basis of the contract . . . .

Rather, the question is whether the tort claims flow from an independent duty under tort law." Id. at 607. The Court further noted: "There is an important distinction between failure to perform the contract itself, and promises that induce a party to enter into a contract in the first place." Id. The Court then found that pre-contractual misrepresentations were "not based on the contract itself—fully integrated or not—but on the principles of duty and reasonable contract." Id. Thus, "a contracting party's negligent misrepresentation of material facts prior to the execution of an agreement may provide the basis for an independent tort claim asserted by a party detrimentally relying on such negligent misrepresentations." Id. (internal quotation marks and citation omitted).

The certified question in this appeal presents the exact type of "altogether different situation" referred to in United Intern Holdings, DeMarco, and the numerous other federal and state authorities cited above. As indicated above, the purpose of the economic loss rule is "to prevent disproportionate liability and allow parties to allocate risk by contract." SME Indus., Inc., 2001 UT 54 at ¶ 36. The parties, however, cannot fairly evaluate their respective risks or adjust their respective obligations and expectations if their bargain is based upon pre-contractual misrepresentations. Accordingly, the law properly recognizes that the economic loss doctrine does not bar fraud-in-the-inducement claims.[3]

[3] The Tenth Circuit's decision in Donner v. Nicklaus, 778 F.3d 857 (10th Cir. 2015), which prompted the United States District Court's decision to certify this issue, is an outlier. Although the Donner Court correctly recognized that Utah Supreme Court has not "confined the economic loss doctrine to wrongdoing taking place after entry into a contract," it ignored Utah's historical approach to determining whether actions by one party to the contract give rise to liability in tort law, contract law, or both. Synergy and Nature's Sunshine respectfully submit that Donner was wrongfully decided. In any

II. The Economic Loss Rule Does Not Bar a Fraudulent Inducement Cause of Action Because Fraudulent Inducement Is Based Upon the Breach of an Independent Duty of Care.

Fraudulent inducement claims arise out of an independent tort duty of care – namely, the duty to be honest and candid with respect to facts material to a transaction. This Court has previously instructed that the source of the duty between the parties determines whether the economic loss doctrine precludes the cause of action. See, e.g. Hermansen, 2002 UT 52, ¶¶ 16–17 ("the initial inquiry in cases where the line between contract and tort blurs is whether a duty exists independent of any contractual obligations between the parties."); see also Grynberg, 2003 UT 8, ¶ 44 ("Contractual duties exist by mutual agreement of the parties, while tort duties exist by imposition of society; the modern focus is not on the harm that occurs but instead is on the source of the duty that was breached....")

Virtually every jurisdiction that has evaluated the economic loss rule has concluded that the law recognizes an independent duty to be honest in pre-contractual negotiations. See Ralph C. Anzivino, The Fraud in the Inducement Exception to the Economic Loss Doctrine, 90 Marq. L. Rev. 921, 932 n.66 (2007) (collecting cases).[4] Specifically, the duty

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event, Donner is readily distinguishable in that involved a claim for negligent misrepresentation, as opposed to an intentional tort.

[4] See also Abi-Najm v. Concord Condominium LLC, 699 S.E.2d 483, 490 (Va. 2010); Wyle v. Lees, 33 A.3d 1187, 1191–92 (N.H. 2011); Ulbrich v. Groth, 78 A.3d 76, 98–99 (Conn. 2013); Van Rees v. Unleaded Software, Inc., 373 P.3d 603, 607 (Colo. 2016).

has been announced in the Restatement (Second of Torts) § 551, labeled "Liability for Nondisclosure," which states:

> One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated . . .
>
> (b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading; and . . .
>
> (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

Id.; see also First Sec. Bank of Utah N.A. v. Banberry Dev. Corp., 786 P.2d 1326, 1330-31 (Utah 1990) (citing Restatement (Second) Torts § 551 with approval); see also MP Nexlevel, LLC, 2010 U.S. Dist. Lexis 40828 at *15 (holding that "[t]he law, not the contract, imposed a duty on [defendant] not to make material misrepresentations of fact" and refusing to apply economic loss rule as a result).

Numerous illustrations follow in the comments to Restatement Section 551. For instance, regarding facts basic to the transaction, there is this example: "A sells B a dwelling house, without disclosing to B the fact that the house is riddled with termites. This is a fact basic to the transaction." And another,

> a seller who knows that his cattle are infected with tick fever or contagious abortion is not free to unload them on the buyer and take his money, when he knows that the buyer is unaware of the fact, could not easily discover it, would not dream of entering into the bargain if he knew and is relying upon the seller's good faith and common honesty to disclose any such fact if it is true.

These examples illustrate that the duty to be honest in pre-contractual interactions does not emanate from any contract—but instead "from the interdependent nature of human society." Reighard, 2012 UT 45, ¶ 19.

Section 530 of the Restatement also reiterates a similar concept, stating, in part, that a "representation of the maker's own intention to do or not to do a particular thing is fraudulent if he does not have that intention." Comment C expands:

> Since a promise necessarily carries with it the implied assertion of an intention to perform it follows that a promise made without such an intention is fraudulent and actionable in deceit under the rule stated in § 525. This is true whether or not the promise is enforceable as a contract. If it is enforceable, the person misled by the representation has a cause of action in tort as an alternative at least, and perhaps in some instances in addition to his cause of action on the contract . . . . [I]t is immaterial to the tort liability that the damages recoverable are identical with, or substantially the same as, those which could have been recovered in an action of contract if the promise were enforceable.

Though the Restatement does not include an example for when an action in tort may be brought "in addition to [the] cause of action on the contract," it has been applied to include claims for fraudulent inducement. Coutu v. State, No. 2015-CV-488, 2017 N.H. Super. Lexis 4, at *6–*9 (N.H. Super. Ct. Mar. 15, 2017) ("That a fraudulent misrepresentation claim may be made in tandem with a contract claim is made plain by Comment c to Restatement (2d) Torts § 530 . . . . But the principle that tort claims exist when there has been a fraudulent inducement to perform or enter into a contract does not relate to the benefit of the bargain at all. Rather, it relates to whether or not one party obtains a benefit which was not bargained for at all because of one party's deceit. In such

circumstances, it makes sense that a party should have remedies other than those he could have bargained for.").

The concepts outlined in the Restatement logically apply with respect to a claim for fraudulent inducement, as well as to the facts presented by this case. Here, Synergy brought an alternative claim against HealthBanc for fraud in the inducement because HealthBanc misrepresented material facts that were basic to the transaction – namely, that HealthBanc actually owned the subject formula and purported intellectual property rights. Synergy would not have entered into the transaction on the same terms, if it all, if it had known that HealthBanc did not own any intellectual property rights. HealthBanc had an independent common law duty to disclose (or at least not affirmatively misrepresent) its lack of ownership. Thus, the economic loss rule should not bar a claim for fraud in the inducement that is based upon a pre-contractual misrepresentation, since the claim is based upon the breach of an independent duty of care.

III. The Economic Loss Doctrine Should Not Shield a Defendant Who Commits Fraud.

Finally, this Court should hold that the economic loss doctrine does not bar fraudulent inducement claims because any other result would effectively reward a party for its own fraudulent misconduct. In American Towers, this Court adopted the economic loss doctrine because it was concerned that extending tort law when there is a valid contract "would result in liability in an indeterminate amount for an indeterminate time to an indeterminate class." American Towers, 930 P.2d at 1190 (internal quotation marks omitted). Put differently, this Court wanted to avoid "impos[ing] the plaintiffs' economic

expectations upon parties whom the plaintiffs did not know and with whom they did not deal and upon contracts to which they were not a party." SME Indus. Inc., 2001 UT 54, ¶ 35 (internal quotation marks and alterations omitted).

Imposing tort liability for fraudulent inducement, however, does not create the problem of the "indeterminates" because it necessarily relates only to the contracting parties, thus avoiding unanticipated third-party liability. And to prevent a party from bringing a claim for fraudulent inducement simply because they also happen to be parties to a contract swings the pendulum the opposite direction, by allowing contract law to deprive a litigant of a legitimate tort claim. More importantly, such a rule effectively rewards the fraud tortfeasor, by allowing the tortfeasor to limit its damages through contract and to limit the plaintiff's potential remedies for the misconduct. As a recent Utah federal district court decision noted:

> Indeed, it would be nonsensical if the economic loss rule could shield a defendant from tort liability based on the mere fact that a contract later formed. The purpose of the economic loss rule is to promote the allocation of risk through contract. In this case, [the plaintiff] could never intelligently negotiate and allocate risk under the terms of the [Agreement] where [plaintiff] was allegedly brought to the bargaining table under false pretenses.

Preventive Energy Solutions, 2017 U.S. Dist. Lexis 4195, *19–*20 (citing West v. Inter-Financial, Inc., 2006 UT App 222, ¶ 10, 139 P.3d 1059).

Equity would suggest that the risk of committing fraud should be borne by the tortfeasor, not the victim of the tort. Accordingly, sound policy favors the conclusion that the economic loss rule does not bar fraud-in-the-inducement claims.

CONCLUSION

For the reasons expressed herein, Synergy and Nature's Sunshine respectfully submit that the Court should answer the certified question as follows:

1. Does the economic loss rule bar a cause of action for fraudulent inducement that is based on pre-contract misrepresentations that induce another party into entering into a contract?

   ANSWER: No. Because there is an independent duty to avoid fraudulent misrepresentations, the economic loss rule does not bar a cause of action for fraudulent inducement.

DATED this 19th day of January, 2018.

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Certificate of Compliance With Rule 24(f)(1)

I hereby certify that:

1. This brief complies with the type-volume limitation of Utah R. App. P. 24(f) (1) because, excluding the parts of the document exempted by Utah R. App. P. 24(f)(1), this document contains 4,363 words.

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DATED this 19th day of January, 2018.

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CERTIFICATE OF SERVICE

I hereby certify that on January 19, 2018, a true and correct copy of the foregoing document was mailed to the following:

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